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Recommended Citation

Auditing Symposium XII: Proceedings of the 1994 Deloitte & Touche/University of Kansas Symposium on Auditing Problems, pp. 154-161;

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What We Can Learn From Yogi Berra

Discussant's Response to "Auditing for Fraud: Perception vs. Reality"

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As a baseball fan, I appreciated that Alan Winters and John Sullivan began their paper, *Auditing for Fraud-Perception vs. Reality*, with a quote from Yogi Berra. They ended their paper with a comment that the profession's history of efforts to grapple with fraud detection already contains too much repetition, calling to mind another famous phrase often attributed to Yogi: It was *déjà vu* all over again. So, in my turn at bat, I plan to follow Alan and John's lead and consider what audit practitioners, educators and researchers can learn from Yogi Berra.

My comments address four questions that Alan and John's paper made me think about, the first two dealing primarily with audit practice, and the other two related more to audit education and research: (1) Why do auditors miss fraud clues or fraud itself? (2) How much assurance is reasonable assurance? (3) Does audit education begin too late? and (4) Do auditor characteristics matter?

Why Do Auditors Miss Fraud Clues or Fraud Itself?

In the body of their paper, Alan and John present a large number of thoughtful observations and interesting suggestions about auditing for fraud. Many of their observations address the implicit question: Why do auditors miss fraud clues or fraud itself? Consider, in response to this question, George Bush's favorite Berra quote concerning Yogi's reason why the Yankees lost the 1960 World Series to the Pirates: "We made too many wrong mistakes."

Let me briefly review four "wrong mistakes" I think auditors make that lead them to miss fraud clues or fraud itself and compare and contrast my views to those expressed in Alan and John's paper.

The first wrong mistake: expecting too much of the fraud risk model

First, auditors make the wrong mistake of looking too hopefully at the fraud risk model for strong predictive relationships. Alan and John focus most of their criticisms on the fraud risk model and I find most of their criticisms well taken, as well as their conclusion that the risk model, as currently expressed in the literature, can and should be significantly improved based on what we've learned since SAS #53. But, I also think we must recognize that even if we improve the fraud risk model in every feasible way, there will still be a limit to the predictive ability it can provide us.

Let me put on my hat as an educator for a moment to explain why this is so. One of the challenges that faces us as teachers of auditing is to explain to our students, who have never been on an audit, what we mean when auditors talk about becoming "satisfied" about an audit objective, or feeling "comfort" about an audit conclusion. What

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we're trying to communicate, of course, is the notion of second order uncertainty that we were discussing earlier today in conjunction with Bill Waller's paper. So, I create a very simplified explanation for my students. I tell them that audits involve a multitude of decisions and that the decision tasks fall roughly into three groups.

The first and largest group—knowledge tasks—contains those tasks where there's an almost deterministic relationship between the available evidence and the decision at hand. Examples of knowledge tasks include deciding whether depreciation expense was calculated correctly and deciding whether the inventory count was accurate. When you make these decisions as an auditor, you can never be 100% guaranteed you are right, but you're close enough to certainty for all practical purposes.

The second group—which is smaller than the first, but which has more value-added and thus is what we get paid more for—contains judgment tasks. For judgment tasks, there's a more probabilistic relationship between the available evidence and the decision at hand, as, for example, when an auditor decides whether the net book value of accounts receivable is collectible. The relationship is predictable over many clients, or for a single client over the long run, but for any individual client in an individual year, the auditor must live with more than a minimal level of uncertainty.

In terms of a more formal model, what we're talking about here is second order uncertainty: the auditor will always experience greater second order uncertainty for judgment tasks than for knowledge tasks. And here's where the rub is: many error detection tasks are knowledge tasks, but fraud detection is now—and will always be, no matter how close to optimal we make the fraud risk model—a judgment task. There is a limit to the degree of satisfaction auditors can feel about fraud detection that will always be lower than the degree of satisfaction we can feel about error detection. So, my warning is that we shouldn't oversell improvement of the fraud risk model. We can take a step forward, but not the entire journey.

By the way, in case you're curious, the third group of decision tasks—which, fortunately, I believe is rare (though not non-existent) on an audit—is guessing tasks, tasks where there is little or no relationship between the available evidence and the decision at hand. My usual example for students of a guessing task is the decision about whether tax law changes in the next five or ten years will affect the amount that should be recognized today in the long-term deferred taxes accounts.

The second wrong mistake: failing to remember “too” normal may be a red flag

The second wrong mistake auditors make is being too focused on looking for abnormalities. Focusing on deviations from expectations works better for error detection than for fraud detection. For instance, abnormal results from analytical procedures can help the auditor find the dumb frauds, but they're not much help finding the smart ones—the ones where the fraud perpetrators are at least as smart as (or, in some cases, smarter than) the auditors and deliberately set out to deceive the auditors.

Auditors too often forget the simplest rule of manipulation: Make it look normal. As Barry Minkow, architect of the ZZZZ Best fraud, says in a videotaped interview produced by the Institute of Certified Fraud Examiners, “The number one thing we had to do as a fraud team was CONSISTENCY.” Thus, auditors shouldn't focus only on abnormalities, but should also look for results that are *too* consistent, too normal, or too good to be true. That doesn't mean that auditors should be skeptical of everything—but it does mean they should recognize that deviation from expectations isn't the only warning signal to watch for on an audit.

Consider another teaching example. If a student hands in a homework problem that comes pretty close to the solution manual, as a teacher, I'm happy. But if that student

keeps on handing in homework that always tracks the solution manual, pretty soon I begin to suspect that maybe the student *has* the solution manual. To ignore that possibility would be naive.... and that's true even though no one's likely to sue me if I miss a manipulation.

The famous ZZZZ Best fraud, which Alan and John refer to in their paper, provides an illustration of how auditors can miss a manipulation by failing to notice the too good to be true. For example, the auditors examined one-page building restoration contracts worth millions of dollars. While one might fervently wish to encourage simplification of legal jargon, the one-page contract seems too good to be true. How many multi-million dollar legal contracts have you seen without pages and pages of specifics? Or, consider that when the auditors went to observe the work at a building being restored after fire damage, they found the building in almost pristine condition, with no real evidence of remaining damage and little evidence of continuing work. Even for an almost completed project, this would be too good to be true. Real life is rarely seamless; seamless evidence may not be real.

The fraud risk model, as currently expressed in the practice and research literature that Alan and John discuss, reinforces the auditors' tendency to focus on deviations from expectations. Consider that even the term "red flags," the popular name for fraud risk indicators, refers to something which jumps out at you as different than normal. If we want to improve fraud detection, we need to expand our notion of fraud clues to include the too good to be true, as well as the abnormal deviations. Moreover, even if we improve the risk model, we still need to consider improving education and firm training of auditors to improve auditors' ability to focus on the too good to be true, as well as observed abnormalities. One way to do this might be to build more observation exercises into the college classroom and firm training programs, with care taken to include cases with abnormalities, normal cases, and too good to be true cases. It is also important to consider the too good to be true problem when teaching about performing analytical procedures. Too often, the sole focus of analytical procedures is looking for material deviations from expectations, which is very helpful in locating errors. But if the books have been cooked, one sign may be ratios and trends with too little deviations, another case of too good to be true results.

The third wrong mistake: insufficient industry/benchmarking knowledge

Another wrong mistake auditors make may be found in the fraud cases where better industry knowledge and better benchmarking could have provided clear red flags that the books were being cooked. To use the ZZZZ Best case again as an example, remember that ZZZZ Best hid material losses from their legitimate carpet cleaning business in mounds of false profits from a phony fire restoration business. In this case, the auditors examined fictitious restoration contracts for \$7 to \$8 million apiece, but failed to see the red flag as they were unaware of industry data which reported that the largest restoration jobs on record were in the \$2 to \$3 million range.

Mistakes related to insufficient industry/benchmarking knowledge are not just a recent phenomenon. When I was an undergraduate auditing student back in the 1960s, audit texts often used the example of the "Great Salad Oil Swindle," an inventory fraud case that could have been detected earlier by better use of industry knowledge and benchmarking. In this case, a subsidiary of American Express created fictitious inventory at a New Jersey storage tank farm by floating a layer of salad oil on top of tanks filled mostly with water. When the auditors observed and tested the tanks' content, they saw and smelled salad oil, and thought the tanks were full of oil. But, had the auditors been aware of published industry data, they would have known that

the amount of salad oil claimed to be stored in this one New Jersey location was a highly unreasonable amount in comparison to the previous year's world production.

With the advent of advanced technology and the greatly increased access to industry information via electronic databases, more sophisticated industry knowledge and benchmarks should be much easier to create than in the past. Yet, as the ZZZZ Best case reveals, auditors keep repeating the same "wrong mistake" of not taking advantage of available information. In addition to improving the fraud risk model, we must also improve the use of industry knowledge and benchmarking when auditors conduct analytical procedures.

The fourth wrong mistake: not leading with the strongest hitters

In the game of baseball, it's generally considered good planning to lead off with some of your strongest hitters. Yet, on audit teams, we tend to bat our rookies at the top of the order when it comes to field work. Yogi would not approve.

The traditionally-structured audit team made sense in the era when it was first created. At that time, the focus of an audit was more on error detection than on fraud detection and accounting systems (and audits) were largely manual. This environment required small armies of accounting clerks to create the books and small armies of audit laborers to perform the kind of tedious testing that went by such monikers as "tick and tie." But with advanced technology, accounting systems are now largely computerized from automated data entry via barcode scanners and electronic data interchange, through electronic processing, storage and reporting. Many of the computational tests in the audit process have likewise been computerized.

In this electronic information environment, increased input accuracy and built-in error checking have become the norm for accounting systems. Consequently, errors are less frequent than they were in manual systems. On the other hand, electronic information systems create new opportunities for manipulation, broadening the range of potential frauds. Thus, as technology has changed, error detection has become relatively less important and fraud detection has become relatively more important. Moreover, audit technology has removed most of the laborious tick and tie tasks from human hands to electronic testing, raising the level of sophistication of tasks now done by people at the lowest level of the audit team.

How could we strengthen the batting average of an audit team when it comes to fraud detection? Let me offer two suggestions Yogi might give: (1) more coaching, and (2) more farm team experience before moving to the major leagues.

More coaching could be provided by increased formal education, as the proponents of expanding entry-level education to 150-hours or graduate degrees in accounting advocate. More coaching could also be provided within the firms by having the experienced "pros"—the managers and partners—mentor the inexperienced rookies on the audit staff. Traditionally, manager/partner contact with junior staff members has been limited, with several layers of the management hierarchy filtering communication between the top and bottom levels. Again, this made sense in the days when public accounting firms were structured as pyramids with very wide bases and narrow peaks, and with a great deal of turnover (both voluntary and involuntary) in between. Yet, in the current environment, the traditional pyramid structure is being replaced by something that is beginning to look more like a cylinder. With this structure, direct mentoring by partners and managers may be feasible and cost effective. It should at least be explored as a possible way to leverage the batting power of the rookies on the team.

More farm team experience might also be in order. Traditionally, the best and brightest graduates of our accounting programs have often begun their careers in

public accounting. Then, after two to four years experience, many of these graduates have left public accounting for careers in industry or government. Public accounting, in effect, served as a training ground for auditors in other sectors of the profession. This made sense to public accounting firms because the nature of their industry required those armies of bodies at the entry level and high turnover. It made sense to young accountants because they got broad-based audit experience and great on-the-job and continuing education training, which added up to a *de facto* graduate school. It made sense to industry and government, because they got experienced hires who were ready to hit the fast track when they came on board, particularly because experience transferred easily in an age of manual information systems.

But again, changing technology and other changes in the environment—including the greater sophistication needed to audit a broad range of computerized global clients and increased competitiveness in public accounting—make the old system questionable. Is it still economically efficient to use public accounting as the farm team for other sectors of the profession? Or, has the situation now reversed so that it may make more sense to have young accountants begin their careers in industry or government and then, after two to four years of experience, enter a public accounting firm if they wish to be financial auditors?

How Much Assurance Is Reasonable Assurance?

I take issue with Alan and John's paper (which I often agree with) most severely when it comes to the topic of reasonable assurance. None of us in practice, education or research like the question: How much assurance is reasonable assurance? As Yogi Berra once said when asked for the umpteenth time about the dismal record of his 1984 Yankees: "I wish I had an answer to that question because I'm getting tired of answering that question."

In their paper, Alan and John argue that auditors believe a reasonable level of assurance is *lower* for fraud than error, but users believe a reasonable level of assurance is the *same* for both error and fraud:

We think that report readers believe that the auditor is responsible for and can detect all misstatements, irrespective of whether they are errors, management fraud, or defalcations, with the same level of assurance, while auditors do not. In other words, auditors believe what is a "reasonable" level of assurance for detecting a misstatement varies with the nature of the misstatement while report readers believe that this "reasonable" level of assurance is the same for all misstatements.

I think this argument seriously understates the true magnitude of the expectation gap. There is ample evidence in the research literature to tell us that investors want *more* (not the same) assurance against fraud than error. For example, the January 1994 *Journal of Accountancy* included an article on audit assurance by Epstein and Geiger reporting the results of a national survey of shareholders, one of the primary user groups for audit reports. Consider the following table which reveals the results of one of the survey's key questions:

Investor perceptions of audit assurance

The auditor should do whatever investigation is necessary so he or she can provide assurance the audited financial statements are free from material misstatements. This assurance should be described as follows:

	Error	Fraud
No assurance necessary	1.67%	2.51%
Reasonable assurance	51.05%	26.36%
Absolute assurance	47.28%	71.13%

From: Marc J. Epstein and Marshall A. Geiger, "Investor Views of Audit Assurance: Recent Evidence of The Expectation Gap," *Journal of Accountancy*, January 1994, p. 60.

The expectation gap is not less assurance for fraud versus error on the auditor side versus the *same* assurance on the user side; it's less assurance on the auditor side versus *more* assurance on the user side. I think it's very important that practitioners, and especially standard-setters, acknowledge the true magnitude of the expectation gap. Acknowledging the true size of the expectation gap is important because the gap is not likely to be closed by one side or the other moving completely to the opposite side's position, but by both sides compromising. From the viewpoint of Alan and John's paper, reducing the expectation gap by moving to the same level of assurance for fraud and error would be regarded as a capitulation where auditors give in entirely to users. But, if the real magnitude of the expectation gap is acknowledged, it becomes clear that moving to the same level of assurance for fraud and error would be a compromise for *both* sides, not merely a one-sided capitulation. Until auditors recognize the true magnitude of the expectation gap, it is unlikely that a mutually acceptable resolution of the gap can be achieved.

Alan and John's paper contains another argument which shows, in my view, further evidence that auditors in practice often understate the reality of the expectation gap. In their call for an "unambiguous statement of responsibility to detect fraud," Alan and John make the dual points that auditors must detach from their old, entrenched belief that they can disavow responsibility for fraud detection and that the public must also detach from their old, entrenched belief that auditors can detect all frauds. So far, so good. But then, Alan and John go on to explain how the public should come to view missed cases of fraud by drawing an analogy to the responsibility of police officers to find criminals:

We believe the responsibility to detect fraud is analogous to the responsibility of police officers to find criminals. It would be absurd for police officers to deny such a responsibility, but it would be unreasonable to expect them to always find criminals. We believe that the public understands and accepts this for police officers, but not for auditors. Restating the auditor's responsibility for fraud more precisely and coherently in professional standards could help achieve this understanding and acceptance.

This is an interesting analogy, but it hasn't been thought through. Let's take a closer look for a moment at the notion that the public understands and accepts the failure of police officers to find criminals. Make the analogy a bit more specific by thinking about a particular crime analogous in severity to financial fraud. Since most companies don't die from fraud, we'll reject murder as the crime; but since they suffer greatly from the violation, rape would seem to be an appropriate analogy.

Now, ask yourself the question: Does the public understand and accept that some rapes go unsolved? At best, I think you could argue that the public at large accepts the

abstract notion that some rapists are undiscovered, but it would be unreasonable to argue that the victims of rape, or their families and close friends, feel the same way. Those affected by the crime do not accept or understand the failure to catch the rapist in the same way those unaffected by the crime might. And those who are affected by crime can include a pretty broad circle beyond the victim and the victim's family and close friends. While you may, in general, be tolerant that some rapes go unsolved, you will less likely be tolerant if the unsolved rape occurred in the parking garage of your building on the floor above where you park.

Here's where Alan and John's police officers analogy leads us: the public in general may be tolerant, but victims, both direct and indirect, care. The problem for auditors is immediately apparent. Financial frauds, particularly in public companies, have huge numbers of victims—and victims care. The analogy of "suite crime" (management fraud) to street crime, is a good one; but, when the analogy is carried through, it leads not to the logical conclusion that the public should be more forgiving of undetected crime, but to the conclusion that the pressure to keep the streets safe will continue.

Does Audit Education Begin Too Late?

Since I have been somewhat critical of practice so far, in the interest of fair play, let me also take a swing at academia. As academics, one Yogi-ism we should think about is Berra's explanation of why he missed a ball when playing left field in an afternoon game of the 1961 World Series: "It gets late early out there."

As educators, we need to recognize that time is not on our side when it comes to audit education: it gets late early out there. Consequently, in my view, audit education should begin earlier than it does in the traditional undergraduate curriculum. In the traditional curriculum, audit education occurs at the end of an accounting majors' coursework. Presumably, this placement of audit education within the curriculum arose from the notion that you can't learn how to audit until you've already learned about the financial accounting, managerial accounting, systems and tax aspects of organizations. While there's definitely merit in this notion, it applies more to audit procedures than to basic audit concepts. Basic audit concepts—including basic coverage of fraudulent financial reporting—should be taught earlier in the curriculum, and they should be taught to non-majors as well as majors.

By confining audit education to upper division auditing courses, we are missing our best opportunity to educate USERS of audit reports. The introductory accounting sequence is the only exposure most non-accounting business students and non-business majors ever have to accounting. It is ludicrous to constantly talk about the need to reduce the expectation gap, yet to ignore our only opportunity to talk to future users of audit reports about the role of auditing in society. Instead of talking about auditing only in a course for majors, we need to begin audit education at the introductory level. At the introductory level at the University of Southern California, for the past three years we have been introducing students to the meaning of the different types of audit reports, the nature of audits, the value of audits, and the types of testing and evidence auditors use. As a result, non-accounting students have a much clearer understanding of what an audit is about and they are more likely to correctly interpret the meaning of an audit opinion. In addition, we cover basic aspects of fraudulent financial reporting—including a discussion of the impact of fraudulent financial reporting, and a discussion of the roles of various parties (management, the board of directors, internal and external auditors, and regulators) in preventing, detecting and disciplining fraud. This type of early education raises awareness of the importance of maintaining the

quality and credibility of financial reports and places a strong emphasis on the ethical responsibilities of managers in setting an appropriate control environment to help reduce the incidence of fraudulent financial reporting.

Starting audit education early in the curriculum has added benefits for accounting majors. By confining audit education to a single course late in the traditional curriculum, we force some topics, including fraudulent financial reporting, to be treated too simplistically. We only have enough time in a traditional auditing course to cover the most basic aspects of fraudulent financial reporting. But, if these basic aspects were covered in the introductory course, the later courses could move to more complex aspects of the topic. For instance, if students come to their upper division auditing course already aware of the auditor's use of analytical procedures to assess risk, the auditing course can then focus on more complex aspects of risk assessment, such as the "too good to be true" problem mentioned earlier.

Do Auditor Characteristics Matter?

Finally, while I realize that Alan and John's focus is on fraud detection in practice, I can't resist making one observation about research. Those of us who spend part of our lives doing academic audit research might want to consider a comment Yogi Berra once made about the game of baseball: "Ninety percent of this game is half mental."

In pondering Yogi's unique phrasing, we might want to ask ourselves a question about research on auditors as fraud detectors: Do auditor characteristics matter? That is, if client characteristics help predict who is more likely to commit fraud, can auditor characteristics help predict who is more likely to detect it?

Earlier, I criticized practitioners for focusing only on large numerical deviations observed in doing analytical procedures. But, we researchers are guilty of a similar narrow focus when it comes to research on fraud detection. We tend to focus our efforts too much on empirical research on fraud risk factors (which red flags are the best fraud predictors?) and too little on the human judgment side of fraud detection. This occurs despite intriguing evidence building up in the auditing literature that such variables as sensitivity to integrity (e.g., the body of research on moral development using the work of Kohlberg as a model) and tolerance for ambiguity vary greatly among auditors. The role of auditor characteristics in audit judgment—particularly, fraud detection judgments—is an under-researched area that holds potential as a second line of attack directed toward potential improvement of fraud detection.

It's time to open the floor for discussion now, which reminds me of one last Yogi quote, Berra's description of his experience attending a 1985 White House dinner: "It was hard to have a conversation with anyone, there were so many people talking."

So, in closing, I would like to express my thanks to Deloitte & Touche and the University of Kansas for making it possible for so many people to come together to talk about such interesting topics as auditing for fraud.